Internal Revenue Service

memorandum

CC:TL-N-3484-88
Br2:DCFegan

date: APR 28 1988

to: District Counsel, New Orleans, Louisiana CC:NO

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in reply to your memorandum of February 11, 1988, requesting technical advice concerning the above-captioned case [redacted].

ISSUES

(1) Whether dividend equivalence on the facts presented should be determined by application of the tests set forth in section 302(b) of the Internal Revenue Code or by application of the "effect of the boot" test enunciated in Shimberg v. United States, 577 F. 2d 283 (5th Cir 1978).

(2) Whether the attribution rules of section 318 apply in determining dividend equivalence on the facts of this case in pre-TEFRA years.

(3) Whether Option I is a valid option for purposes of section 318(a)(4).

(4) Whether Option I had a value sufficient to distort an otherwise pro rata distribution.

CONCLUSION

Dividend equivalence in this case should be determined by application of the tests set forth in section 302(b) of the Code. The attribution rules of section 318, including the option attribution rule of section 318(a)(4), apply to the tests of dividend equivalence under section 302(b).

Applying the section 302(b) tests together with the attribution rules, we conclude dividend equivalence is lacking. We agree with the petitioner that the distribution was a stock redemption giving rise to capital gain. The issue should be conceded by our office.

FACTS 1/

On [redacted], the stockholders and Board of Directors of [redacted], a Louisiana corporation operating a [redacted] in [redacted] Louisiana, met and decided to reorganize the corporation so that [redacted], a [redacted] of the [redacted] and the petitioner-husband herein, could become a stockholder in the corporation. Because of the sizeable net worth of the corporation and the limited funds of petitioner-husband, petitioner-husband was unable to purchase the desired quantity of stock in the corporation before the reorganization. It was therefore decided that the corporation would change its name to [redacted] (a wholly owned personal holding company of [redacted], the sole shareholder of [redacted]), and that a new corporation would be formed and named [redacted] (hereinafter referred to as "[redacted]"). The value of the new corporation's stock was to be $[redacted] per share, with [redacted] owning [redacted] or [redacted]% and petitioner-husband owning [redacted] or [redacted]% of the new corporation's stock.

Petitioner-husband purchased his stock at a cost of $[redacted], which he paid with $[redacted] of his own money and $[redacted] that he borrowed from [redacted]. A note in the amount of $[redacted] was given to [redacted] by petitioner-husband, and the note was secured by a pledge of the [redacted] shares of petitioner-husband's stock to [redacted]. [redacted] paid for its stock with the assets and liabilities of the old corporation, plus a note for the difference between the value of the stock, $[redacted], and the net value of the assets and liabilities transferred.

On or after [redacted], [redacted] (the son of [redacted]) purchased [redacted] shares of [redacted] stock. [redacted] (hereinafter referred to as "[redacted]"), reported on his [redacted] federal income tax return that he paid $[redacted] for his shares on [redacted]. According to [redacted] (a CPA and partner in the accounting firm of [redacted] that maintained the books and records of [redacted] during the period up to [redacted]), the $[redacted] price was an estimate and subject to revision once the net worth of the corporation was determined. Apparently, the net worth was determined on [redacted], and the value of the stock was determined to be $[redacted] per share. Accordingly, [redacted] was charged an additional $[redacted] for his [redacted] shares of stock purchased in [redacted].

1/ The facts have been adopted almost verbatim from your request for technical advice.

In [redacted], petitioner-husband sold [redacted] shares of [redacted] stock to [redacted] for $[redacted]. According to [redacted], petitioner-husband received $[redacted] per share for the [redacted] shares. Part of the sales agreement provided that petitioner-husband had an "option" (Option I) to repurchase the [redacted] shares of stock if certain conditions were met. By [redacted], the distribution of stock in [redacted] had changed as follows: [redacted] - [redacted]%; [redacted] - [redacted]%; petitioner-husband - [redacted]%.

Sometime during [redacted], the directors of [redacted] decided upon a second reorganization of the [redacted]. To accomplish the reorganization, several steps were initiated as follows:

1) [redacted], wholly owned by [redacted], was formed on [redacted]. Nothing was in it except nominal stock interests. It was formed to receive the operating assets of the [redacted].

2) On [redacted], [redacted] was merged into [redacted].

3) On [redacted], [redacted] received all of the operating assets of [redacted] in exchange for its ([redacted]) stock, and operated the [redacted] under the name of "[redacted]"

4) On [redacted], the name of [redacted] was changed to [redacted] (hereinafter referred to as "[redacted]").

5) On [redacted], [redacted] began operating. The remaining assets of [redacted] remained in [redacted].

6) On [redacted], [redacted] and petitioner-husband entered into an agreement in which petitioner-husband agreed to purchase [redacted]% of the stock of [redacted], and also in which [redacted] and petitioner-husband agreed to enter into an agreement on [redacted].

7) On [redacted], [redacted], individually and on behalf of [redacted], and [redacted], and petitioner-husband entered into an agreement termed: "Stock Sale and

Redemption Agreement." In this agreement, the parties thereto agree that petitioner-husband would have his [redacted] remaining shares of [redacted] stock "redeemed" by said corporation, effective [redacted], for $[redacted] and that petitioner-husband would receive an "option" (Option II) to purchase [redacted]% of the stock of [redacted]. The $[redacted] was based upon the book value of the [redacted] stock as of [redacted].

8) On or before [redacted], petitioner-husband received the following checks:

a. $[redacted] from [redacted], dated [redacted]; and

b. $[redacted] from [redacted], dated [redacted].

These amounts were paid out of the accumulated and current earnings of [redacted], and moreover, they were based upon petitioner-husband's percentage share of the total outstanding stock of [redacted].

9) The remaining $[redacted] was held in escrow for petitioner-husband until [redacted], so that he would have the amount required as payment for the [redacted]% ownership in [redacted].

Petitioners did not report any of the income received on their [redacted] stock transactions. Petitioner-husband was [redacted] arising from the [redacted] stock transactions.

On [redacted], the Service mailed to petitioners a notice of deficiency which included adjustments for the omitted income from the [redacted] stock transactions. The Service determined that the $[redacted] of income received by petitioners in [redacted] should be treated as capital gains and the $[redacted] of income received in [redacted] should be treated as dividends. The fraud addition to the tax was asserted against petitioner-husband due to the underpayment of tax, resulting from the omission of the [redacted] stock transactions income. Petitioners have only contested the Service's determination that the [redacted] income should be treated as dividends.

Petitioners contend that the [redacted] distribution of $[redacted] was in complete redemption of petitioner-husband's

[redacted] shares of [redacted], and therefore that the distribution should be taxed at capital gain rates, pursuant to sections 301(c), 302(b) and 1202(a). Petitioners contend that there was either a complete termination, or a disproportionate reduction, of their interest in [redacted], and therefore the distribution should be treated as an exchange under section 302(b)(2) or (3).

The Examination Division denied redemption treatment to petitioners' distribution because petitioners' ownership of Option II, after the "redemption", prevented a "complete termination" and a "substantially disproportionate" reduction in petitioner-husband's stock ownership. Accordingly, the Examination Division determined that the distribution was a dividend and should be taxed pursuant to section 301(c)(1).

Once the case was docketed and during the Appeals Office's consideration, the review of the case by your office resulted in the same position as the Examination Division, but for different reasons. You concluded that the [redacted], and [redacted], transactions met the requirements of a reorganization under section 368(a)(1)(D). Having concluded that the distribution occurred during a reorganization, you then concluded that:

> Where a redemption of stock is one of a series of steps in a reorganization, the tax treatment is governed by the provisions of law relating to reorganizations.

See Grubbs v. Commissioner, 39 T.C. 42, 49 (1962).

Petitioners contend that, even if reorganization rules were applicable, the distribution should not be treated as a dividend because the dividend test for distributions made during reorganizations is the same dividend test listed in section 302(b).

Applying the test under section 302(b), petitioners contend that petitioner-husband's ownership in [redacted] was substantially reduced in the [redacted] reorganization. It is petitioners' position that immediately prior to the [redacted] reorganization petitioner-husband held a [redacted]% interest in [redacted]. [redacted] percent was actual ownership and [redacted]% was constructive ownership via the "option" (Option I) that petitioner-husband was granted to repurchase [redacted]% of [redacted] from [redacted]. Petitioners contend that after the [redacted] reorganization, petitioner-husband's ownership was [redacted]% via the "option" (Option II) that petitioner-husband was granted to purchase [redacted]% of the stock of [redacted].

It is within the context of these facts that the four issues set forth at the beginning of this memorandum arise. Regarding these issues, you believe that (1) the applicable test for dividend equivalence is the "effect of the boot" test enunciated in the Shimberg case; (2) the attribution rules appear to be inapplicable in determining dividend equivalence in this case; (3) Option I was a valid option; and (4) Option I had no value of significance.

DISCUSSION

The overall issue in this case is whether the $[redacted] petitioner-husband received in [redacted], should be taxed as ordinary income (i.e. as a dividend). This issue arises out of the vague statutory framework of I.R.C. §§ 354 and 356, which govern the tax consequences of reorganizations to corporate shareholders. Section 354(a)(1) establishes the general rule that no gain or loss is recognized if the shareholder exchanges stock or securities solely for other stock or securities in the same corporation or in another corporation that is a party to the reorganization. Section 356 addresses the situation where boot is received along with stock. Where the boot is in the form of money, as here, gain shall be recognized up to the amount of such money under section 356(a)(1). That gain is capital gain unless it "has the effect of the distribution of a dividend" under section 356(a)(2). In that event, it is treated as ordinary income to each distributee to the extent of his ratable share of undistributed accumulated earnings and profits with the excess being treated as capital gain. 2/

The position of the Service as to the proper test of dividend equivalence under section 356(a)(2) is set forth in Rev. Rul. 74-516, 1974-2 C.B. 121, and Rev. Rul. 75-83, 1975-1 C.B. 112. Our position is that, "it is appropriate to look to principles developed under section 302 for determining dividend equivalence." Rev. Rul. 75-83, supra. This should be our primary position in this case, even though we expect the Tax Court will not apply a strict section 302 analysis.

2/ The facts of this case are not fully clear. We cannot determine for certain whether there was a reorganization. As a result, we are uncertain whether section 356 is applicable to this case or whether there was a simple redemption of petitioner's stock governed by section 302.

However, we do not see this distinction as decisive. If our analysis begins with section 356, then we believe section 302 kicks in through section 356(a)(2). Therefore, whether or not our analysis begins with section 356, we believe section 302 principles are controlling.

The reason we expect the Tax Court will avoid a strict section 302 analysis in this case is that the case is appealable to the Fifth Circuit. The Fifth Circuit decided Shimberg v. United States, 577 F. 2d 283 (5th Cir. 1973). The Fifth Circuit in Shimberg, while not totally rejecting the relevance of section 302 principles in interpreting section 356, refused to apply the "meaningful reduction" test of section 302 in a section 356 (a)(2) context. Cf. Wright v. United States, 482 F. 2d 600 (8th Cir. 1973), and Clark v. Commissioner, 86 T.C. 138 (1986), aff'd, 828 F. 2d 221 (4th Cir. 1987), cert. granted (March, 1988).

Regardless whether the courts were to apply section 302 principles or not, we think the essential point is that Service position is that those principles are appropriate to apply in this situation. 3/ We are constrained to base our primary arguments on published Service position and to argue only secondarily that dividend equivalence exists under the criteria described in Shimberg.

When we argue the application of section 302 principles, we believe we cannot pick and choose what principles are applicable in a section 356(a)(2) context, but must argue those principles are fully applicable. The attribution rules of section 318 are applicable to section 302 by statute. I.R.C. § 318(b)(1). One of those attribution rules is the option attribution rule of section 318(a)(4) under which stock subject to an option held by someone is considered to be owned by that person. 4/

Summarizing the Service's position, section 302 principles control in determining whether there is a dividend and, in applying those principles, stock shall be considered owned by persons having an option to acquire it. When those legal conclusions are applied to the facts of this case, we conclude neither a dividend nor the equivalent of a dividend exists.

3/ Do not be misled by the statements at page 224 of the Clark appellate opinion indicating the Service no longer is of the view section 302 applies in a reorganization setting. Service position remains as stated in Rev. Ruls. 74-516 and 75-83 and there is no move afoot to change that position.

4/ The parenthetical language of section 356(a)(2) was added to the Code to make it clear the attribution rules of section 318(a) apply to determinations of dividend equivalence concerning distributions after August of 1982. However, internally the Service had concluded at an earlier date that section 318 applies when section 302 rules are used to determine dividend equivalence under section 356(a)(2). A ruling project to publish this position was under way when the change in the law made it unnecessary.

Entering the crucial period from [redacted], through [redacted], the petitioner owned [redacted] percent of the stock of [redacted]. [redacted] percent was owned outright and [redacted] percent was attributed to the petitioner as a result of his option to repurchase the shares he sold to [redacted]. In the [redacted] exchange, the petitioner received options to purchase [redacted] percent of the stock of [redacted], a successor corporation receiving the assets of [redacted]. He exercised those options in [redacted]. 5/

The facts disclose the petitioner's interest was reduced from [redacted] percent to [redacted] percent. Suffice it to say such a reduction in interest appears to be a meaningful reduction in the petitioner's interest so as to satisfy section 302(b)(1) and a substantially disproportionate redemption satisfying section 302(b)(2). Accordingly, we conclude the $[redacted] in issue was not a dividend or essentially equivalent to a dividend, but an amount received in redemption of petitioner's stock giving rise to capital gain.

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5/ We place little significance on the conditions associated with the options. They were either conditions solely within the petitioner's control, (such as payment of notes due [redacted]) or conditions that had not occurred but would void the option if they did occur (such as the expiration of five years or petitioner ceasing to be employed by [redacted]). The essential point is that the petitioner had the right to exercise the options during the periods under consideration and could have acquired the stock associated with the options.